Investment Newsletter

February 2019

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Mind the gap

"*In a winner's game the outcome is determined by the correct actions of the winner. In a loser's game, the outcome is determined by mistakes made by the loser*".

Charlie Ellis, the US investment consultant, wrote this in his 1998 book, '*Winning the Loser's Game*'. He was highlighting that, in a similar vein to many sports, investors can lose by their own behaviour rather than being wrong-footed by the winners.

In investment terms the losers (those with lower returns than others) are those who sell low and buy high. This is particularly relevant after a really tough year in markets like 2018.

Behavioural studies have shown that humans don't like loss. In prehistoric times, if you lost your food you might have died. We are hard-wired to avoid it. But falling stock markets cause many investors to enact this loss aversion by hitting the 'sell' button – GET ME OUT! I'VE HAD ENOUGH!

Burger King

Winners think otherwise.

Legendary investor Warren Buffett has undoubtedly been one of the biggest winners in the investment world for over 65 years. He showed how a winner thinks about falling markets – in the same way as he sees hamburgers - in an interview to *Fortune magazine* in December 2001:

"*I'm going to buy hamburgers the rest of my life. When hamburgers go down in price, we sing the 'Hallelujah Chorus' in the Buffett household. When hamburgers go up in price, we weep. For most people, it's the same with*

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everything in life they will be buying — except stocks. When stocks go down and you can get more for your money, people don't like them anymore."

Contrary to the loser, Buffett hits the 'buy' button when markets fall.

The spread between investment returns and investor returns is known as the 'behaviour gap'. It exists because the collective behaviour of millions can overwhelm our senses. Markets are notorious for enticing investors into unforced errors because people feel compelled to react.

Rocky road

It could be argued that these are extreme periods (and pitfalls) are rare. Not so.

For example, many investors believe that the returns from the UK stock market "typically average around 6% - 8% per annum", year-in, year-out.

In fact, returns are much more dispersed with extremes as wide as +30% to -33% over that period. It is these sharp movements in the markets, that spook investors and leads to the unforced errors.

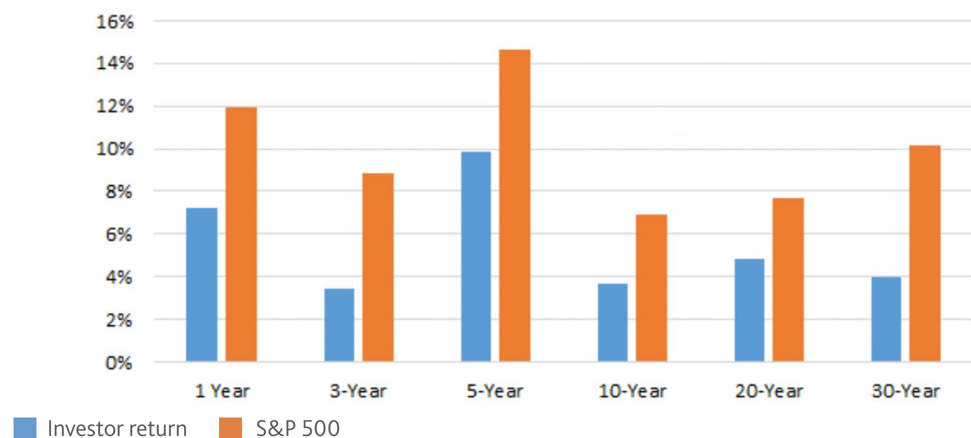
Investment consultancy Dalbar produces a study of the difference between individual investor returns and market returns.

Chart One, below, shows the sharp contrast between the average retail investor return and that of the S&P 500 Index in the US.

For the trailing 10-year period (to the end of 2016) the US stock market earned an annualised 6.95%, or nearly double the investor return of 3.64%.

As Dalbar put it, "No matter what the state of the mutual fund industry, boom or bust investment results are more dependent on investor behaviour than on fund performance. Mutual fund investors who hold on to their investments have been more successful than those who try to time the market."

Chart 1: Investor returns for equity funds vs. S&P 500. Annualised total return (except for 1-year data.)



Source: Dalbar

First aid, then action

We understand this is not easy.

At Equilibrium, we see it as our role to help our clients dodge the unforced errors. Our advisers have worked hard to reassure clients and try to steer them clear of selling into the weakness.

In a report produced by fund house Vanguard, their research found that wealth managers can add around 1.5% per annum to clients' returns by 'behavioural coaching'* alone.

When markets fell last year, we actively used the weakness to buy – singing our own 'Hallelujah Chorus'. For most clients, we invested in volatility trades and a new defined return product, whilst many other investors were selling.

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equilibrium

Strike action

We saw the fruits of our approach just last week when the Morgan Stanley defined returns product kicked-out (matured).

You may recall last February, when markets were running scared over slowing global growth and the prospect of rising interest rates. In the first few weeks of 2018, the FTSE 100 Index fell around 7% and at that point we struck a new structured product with Morgan Stanley. The product returned 12.85% if the FTSE 100 Index was above 7,100 and the S&P Index above 2,583 one year later.

That one-year anniversary was last week, and whilst the S&P Index was comfortably above the level, the FTSE 100 just about made it, closing at 7,129. Over the 12-month period, the total return on the FTSE 100 Index has been 4.83% but the product provided a return of nearly 13% (net of charges) that will contribute to the aggregate performance of the portfolios.

Time in the market, not timin' the market

We try to use times of notable weakness in markets to act like winners. But, like any sport, you need to be playing to have a chance of winning. Similarly, investors need to be invested in markets to have a chance of achieving their desired returns.

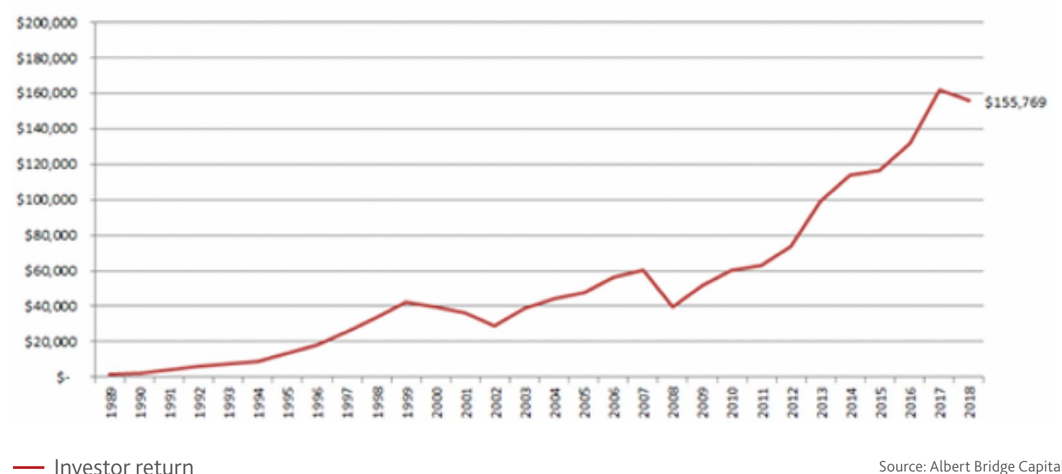
Moving in and out of markets is expensive and is premised on the basis that markets can be timed. This is futile, as underlined by a recent article by Albert Bridge Capital which used the following example.

Suppose you are a market supremo. You invest $1,000 in the stock market (in this case the S&P 500 Index in the US) every single year at exactly the lowest point of the market in that year. You do this for nearly three decades, studiously re-investing the dividends. Your portfolio at the end of last year would be worth $155,769, as shown in Chart Two, below.

Now, suppose you were tragically unlucky enough to buy at the market high each year, over the same period. Year upon year, you continually pay up and buy at the peaks. How much do you think you would have left at the end of 2018? Break-even? Big loss?

The answer is $121,822, just 22% lower.

Chart 2: Investing $1,000 per year (S&P 500, dividends reinvested) 1989-2018



Source: Albert Bridge Capital

Advantage you

Even if your entry point is spectacularly right or woefully wrong, the important element is achieving the returns from the market thereafter (by remaining in the market).

By adhering to these simple rules, we can avoid the markets' temptations of own-goals and hopefully close the gap between intended returns and actual returns.

* *Vanguard Advisor's Alpha: Quantifying your Value to your Clients, 2016*

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equilibrium

General economic overview

Economic data remains mixed although the data from Europe has tended to be weaker than most. Germany narrowly missed entering a technical recession – two successive quarters of negative growth – in figures released two weeks ago.

In the US, the news has been more positive with many asset markets taking solace from the Federal Reserve's statement that it was willing to be 'patient' in the progress of raising interest rates. Investors took this as guidance that interest rates may only rise once or twice more this year compared with previous expectations of three or four rate rises in 2019.

In the UK, it appears that the uncertainty surrounding the Brexit process is having a tangible effect on business confidence and the relative value of sterling.

Equity Markets

The first few weeks of the year have seen a rally in most equity markets. Earnings forecasts have moderated but this has tended to be concentrated in specific areas of weakness such as car manufacturers and retailers. As such, we think there is better value in the US and Japan markets whilst European markets are vulnerable to further downgrades.

The UK market remains undervalued and under-owned by global investors reflecting extreme investor caution regarding the Brexit process. Any reasonable resolution to the situation could result in a strong rally in UK equities.

Fixed Interest

Bond returns are likely to be in the 3-5% return range this year. The indication that interest rates may not be raised as quickly as far as forecast last year is better news as this will reduce pressure on many highly indebted companies and financials. We hold a mixture of corporate and government bonds, including some inflation linked bonds.

Commercial Property

The UK property sector is seeing very modest growth reflecting weaker economic growth and higher funding costs. In our portfolio we look to avoid the weaker areas of retail and Central London which are particularly vulnerable sectors of the market. We are cautious about the outlook and remain underweight given Brexit risks.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced Asset Allocation

For a typical balanced portfolio we are underweight fixed interest and property, and slightly underweight traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile slightly below our average position.

These represent the collective views of Equilibrium Investment Management (EIM). The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.

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